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El Salvador:
A Beleaguered Economy

25X1

An Intelligence Assessment

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ALA 83-10091
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El Salvador: A Beleaguered Economy 25X1

An Intelligence Assessment

This paper was prepared by Office of African and Latin American Analysis. It was coordinated with the National Intelligence Council. 25X1 25X1

Comments and queries are welcome and may be directed to the Chief, Middle America–Caribbean Division, ALA, 25X1

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Key Judgments

Information available as of 1 May 1983 was used in this report.

El Salvador's economy declined for the fourth straight year in 1982, leaving it 25 percent smaller in real terms than in 1978, the last year of relative political stability. Hope for improved conditions, sparked by the massive popular rejection of the insurgents at the polls in March 1982, was shortly snuffed out by a resurgence of guerrilla violence and a deepening of world recession. Because of badly slumping export earnings, pressures on already meager foreign exchange reserves intensified despite major foreign assistance receipts. 25X1

Worsening political and security trends since the summer of 1982 have undermined business confidence and have made the livelihoods of most Salvadorans considerably more difficult. A rise in terrorist attacks, primarily on power or transportation networks and agricultural harvests, and uncertainty regarding government policies have discouraged the private sector. These factors, coupled with inadequate supplies of foreign exchange, have caused gross investment to sag—hitting a new low of roughly 11 percent of GDP in 1982. Meanwhile, declining industrial and agricultural output have pushed El Salvador's unemployment rate above 30 percent. 25X1

We believe the outlook for the economy this year and next remains bleak, as past key impediments to growth persist. Huge world stocks and continued weak prices probably will prevent significant increases in foreign coffee sales, the mainstay of Salvadoran exports. Foreign assistance flows probably will not be appreciably higher than, and may not even match, the $475 million level of 1982. Many industrialized countries want to avoid appearing politically supportive of the present government in its struggle against the insurgents and, therefore, will not contribute sizable amounts of assistance. Finally, the guerrillas have demonstrated by their heightened aggressiveness in recent months their capability extensively to disrupt economic activity, especially in the eastern third of the country. Unless the government finds a way to reduce this capability, El Salvador's economic slide probably will continue through this year and next. 25X1

In our view, any major escalation of the insurgency, resulting in widespread guerrilla control of the countryside closer to San Salvador, probably would have a swift and disastrous effect on the economy. The effects of such a development would be evident in—among other things—a dissolution of remaining business confidence and acceleration of capital flight. In that event, efforts by San Salvador to pursue its struggle against the

guerrillas, to meet emergency needs, and to prevent an economic tailspin would require enormous foreign financial assistance, probably a multiple of the amount presently committed. Even so, little—if any—gains could be expected in the country's development programs. [redacted] 25X1

On the other hand, we believe a significantly reduced guerrilla threat and progress toward political democratization would rejuvenate the private sector, but only slowly. The economy would realize some short-term gains, such as those that could be expected from significantly reduced power outages and lower crop losses. Landowners and businessmen also would be encouraged to revive their investment in capital stock, but progress would necessarily be deliberate until they were convinced that the more stable conditions were permanent. Under these favorable circumstances, the level of foreign financing now envisaged probably would be enough to support an economic recovery this year and next. [redacted] 25X1

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El Salvador: A Beleaguered Economy 25X1

Introduction

El Salvador's prolonged economic tailspin is deepening the government's already grave political and military problems. The shrinking economy is:
- Eroding San Salvador's revenue base for covering critical defense, land reform, and social service needs.
- Undercutting the private sector's willingness to persevere.
- Threatening to wear down popular support for the government's struggle against the insurgents.

This relationship is complicated, in turn, by the feedback of political instability on the economy, causing its further deterioration. 25X1

Large flows of foreign assistance are essential to break the mutually reinforcing cycle of political-military instability and economic decline. Sluggish foreign demand for Salvadoran exports further accentuates the country's financial needs. 25X1

In this paper, we review the factors that have sapped private-sector confidence and caused the severe economic downturn, and we note the consequent growing importance of foreign financial assistance. In this regard, we suggest the magnitude of the impact of differing political-military conditions this year and next on foreign assistance requirements and economic growth. 25X1

The Passing of a Growth Era

Substantial Growth but Uneven Benefits

Between 1960 and 1978, Salvadoran production expanded at a relatively brisk 5.4-percent annual pace. Growth was driven largely by hefty rises in exports of both manufactured goods, such as textiles and metal products, to regional markets within the newly created Central American Common Market (CACM) and agricultural products—coffee, cotton, and sugar—to the United States, especially during the commodity price booms of the 1970s. Meanwhile, gross capital formation, mostly private investment in the industrial sector, nearly doubled as a share of GDP, reaching 23 percent in 1978. 25X1

Table 1
El Salvador:
Gross Fixed Investment Formation

Percent

	Gross Fixed Investment as a Share of GDP	Private Investment as a Share of Gross Fixed Investment	Public Investment as a Share of Gross Fixed Investment
1960	14.4	80	20
1970	11.6	79	21
1973	15.6	72	28
1975	23.0	66	34
1977	21.2	65	35
1978	23.3	70	30
1979	18.6	64	36
1980	12.4	46	54
1981	13.1	46	54
1982	11.0	49	51

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El Salvador's small but powerful economic oligarchy reaped most of the gains, however, while the far more numerous poor benefited little. Chronically high unemployment and underemployment reflected not only the country's overcrowded population but a highly concentrated land ownership and use pattern that provided only subsistence living for most landowners and afforded hundreds of thousands of landless peasants only seasonal opportunities for work. Moreover, despite average yearly increases in per capita income exceeding 2 percent during the period, real wages of urban industrial and rural agricultural workers appear to have declined. 25X1

Crippling Blows to the Economy

Beginning in 1979, El Salvador's economy was battered by a series of internal and external shocks that resulted in a 20-percent decline in real output for the three years ending in 1981. The most destructive shock was the escalation of civil violence into full-fledged insurgency. Antigovernment guerrillas destroyed or damaged productive capacity and seriously disrupted industrial, agricultural, and commercial activity. Sagging business confidence led to the closure of factories—especially in the labor-intensive textiles, apparel, and metal products industries—throughout the country, a sharp decline in private investment, and massive capital flight. According to the US Embassy, by 1981 the insurgents had viewed economic deterioration to be a key ingredient in their strategy to destabilize the government.

In the spring of 1980, a new military junta introduced a series of far-reaching reforms that inadvertently compounded the country's economic difficulties.[1] The package of reforms—including land redistribution, nationalization of banks, and establishment of government monopolies for marketing coffee and sugar—was intended to defuse leftist violence and to promote economic diversification. Because implementation of the land reform in particular was poorly planned and not adequately supported by government technical and credit assistance, the reforms further set back production of cash crops. Delays in implementing Phase I in the land reform's early days because of insufficient preparation enabled large estate owners to remove considerable amounts of machinery and livestock. Later, indecisiveness regarding implementation of Phase II caused widespread uncertainty about future land ownership and has resulted in substantial abandonment of farm operations.

Meanwhile, external developments were adding to the economy's woes. El Salvador suffered a sharp deterioration in its terms of trade with the near tripling of the price of imported oil during 1979-81 and the precipitous drop in the price of coffee, the commodity that consistently had accounted for more than one-half of the country's export earnings. Its previously fast-growing exports of labor-intensive manufacturers, such as textiles and apparel to neighboring countries, also fell off as economic activity in the region began to falter. The resulting drop in export earnings, coupled with increases in the net outflow of private capital, offset by a wide margin a 15-percent average annual rise in foreign official assistance. To minimize the cuts in imports El Salvador was forced to accept, the government drew down its net international reserves (gross reserves minus short-term obligations) from \$252 million in 1978 to \$233 million in the red by the end of 1981 25X1

Aside from the reforms, the junta began to play an unprecedented role in managing the economy in other ways. To shore up aggregate demand and boost employment, the government in 1980 instituted a major expenditure program, known as the National Emergency Plan. The US Embassy reported that San Salvador hiked wage rates, expanded public construction, channeled larger sums of subsidized credit to the private sector, and increased defense spending. Though forced by growing inflation and balance-of-payments deficits to shift somewhat toward austerity in 1981, the government's preeminent position in the economy held. In 1980 and 1981 the public sector for the first time contributed more than one-half of fixed investment. As an unfortunate outgrowth of the government's new economic activism—including the reforms, increased controls, and a greater commandeering of available domestic credit and foreign exchange—the private sector became more mistrustful of the government and even less willing to invest.

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Dashed Hopes for 1982

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Favorable Signs Evaporate

A small economic turnaround appeared possible early last year, but it never materialized. Widespread expectations for the start of world economic recovery, higher coffee prices, and large increases in foreign official assistance seemed to provide grounds for optimism. More important, the insurgents were repulsed militarily and rejected politically during the

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The Guerrilla's Direct Impact on the Economy

The guerrillas' campaign of sabotage, an irritant in the early days of the insurgency, has become a formidable source of economic disruption in El Salvador. Following the failure of their "final" offensive in January 1981, the insurgents began to emphasize economic targeting as a key element in their strategy to wear down the government through prolonged warfare.

The US Embassy estimates the direct costs of the insurgency since its inception to be approximately $600 million, comprised of the following:

- *About 40 percent to damage and production lost in the agricultural sector.*
- *Twenty percent to damage and production lost in the industrial sector.*
- *Fifteen percent to damage and maintenance costs involving economic infrastructure.*
- *Twenty-five percent to increased government spending requirements for defense and assistance to displaced persons.*

On the basis of other information from US officials in San Salvador regarding trends in acreage planted to crops and escalating guerrilla-caused power outages, we judge that the bulk of these costs were incurred over 1981 and 1982.

The economic sabotage has had its military and political benefits for the guerrillas, too. Forced to keep most of its armed forces in static positions to protect economically productive assets as well as civilian population centers, the government has been unable to take the military initiative. Furthermore, the guerrillas' ability to attack electric power systems at will and black out sizable areas of the country for long periods has caused substantial psychological strain on the populace and has discredited the government both at home and abroad.

Approximately one-half of the direct costs of the insurgency to the economy, according to US Embassy reporting, has occurred in the four departments east of the Lempa River—Usulutan, San Miguel, Morazan, and La Union. The guerrillas have maintained a dominant presence in these areas and the damage they have done to productive assets as well as harassment of private producers has been extensive. Repeated sabotage of the electrical power system left these eastern departments without power for about a third of the year in 1982. These power outages in addition to recurrent direct guerrilla attacks have frequently suspended operations in cotton milling cooperatives, coffee mills, food processing facilities, and fertilizer plants. 25X1 *Insurgent attacks, extortion of protection fees and threats to migrant workers and truckers have discouraged the production of cotton and other crops in the east. We believe that, largely because of these guerrilla tactics, the acreage planted to cotton in the region probably is less than one-half that planted in 1979. Moreover, throughout the east, traffic on most road systems—including the Inter-American Highway and the Littoral Highway that link the region with San Salvador—has been subject to regular interdiction. US officials in San Salvador note that the eastern region's share of GNP has fallen by about half.* 25X1

Encouraged by the results of their efforts over the past two years to undermine the Salvadoran economy, the guerrillas probably will intensify their campaign of sabotage this year. In recent months, they have publicly stressed the priority they attach to 25X1 *sabotaging the national economy and have announced cash crop cultivation as a key target. The guerrillas launched a drive in May—a traditionally critical planting time in El Salvador—to disrupt the planting of cotton and processing of coffee, particularly in the east where more than one-half of the country's cotton crop and about 20 percent of the country's coffee crops are located. Local businessmen say the guerrillas are forcing farmers in the region to sign letters stating that they will not plant their crops this season as a condition for their personal security. More than in the past, the insurgents appear to be willing to* 25X1 *intimidate small farmers and peasants in addition to larger landowners. Guerrilla activity also is increasing in the central region, where major hydroelectric power plants are located. Recent attacks on nearby towns underscore guerrilla ambitions to damage or destroy these heavily guarded plants.* 25X1

The Salvadoran Land Reform

On 6 March 1980 the Salvadoran Government inaugurated a land reform program affecting roughly one-third of the country's farmland. The land reform was divided into three phases:

- *The expropriation and redistribution of land under Phase I, involving properties having more than 500 hectares, has been essentially completed. More than half of the country's sugarcane and more than one-third of its cotton are grown on these lands. At the end of 1982, 328 properties had been acquired and converted into farming cooperatives. About 40 of these cooperatives have been abandoned or are operated only sporadically because of their location in guerrilla-infested areas. Compensation for Phase I estates is to be paid solely in bonds with maturities ranging from 20 to 30 years.*

- *Phase II, which calls for the expropriation of estates between 100 hectares and 500 hectares, has not been implemented. These properties contain most of the lucrative coffee-growing areas. Owners of Phase II expropriated farms would be compensated 25 percent in cash and 75 percent in bonds. Because government officials fear that implementation of this phase would seriously hinder the country's cash crop export earnings, it has been shelved.*

- *Phase III, the land-to-tiller stage, was intended to give peasants full title to as much as 7 hectares of farmland that they either rented or tilled at the time of the reform proclamation. This phase is expected eventually to affect 178,000 hectares and to benefit up to 150,000 families. Most of the eligible holdings produce basic grains and cotton. The renter or tiller must take the initiative to seek title. Toward the end of last year, about 58,500 applications had been filed. Provisional titles had been issued to about 60 percent of the applicants, and 1,146 final titles had been issued. Phase III has been a substantial budgetary burden on the government because former owners must be paid 50 percent cash and 50 percent in bonds.* 25X1

Constituent Assembly elections in March. More than 80 percent of eligible voters went to the polls to cast their votes despite guerrilla threats and attacks. The massive turnout appeared to be motivated largely by a popular backlash against guerrilla attacks on economic targets and thus on the people's livelihoods.

Visions of better economic times soon faded. Initial postelection efforts to form a new national unity government were hampered by bickering among political and military leaders, thereby diverting attention from the war and enabling the guerrillas to regroup, rearm, and map new strategies. In the second half of the year, the insurgents resumed their military initiatives with new vigor, sabotaging power, industrial, and transportation facilities, as well as disrupting agricultural activity. At the same time, the government's political squabbling and inconsistent signals regarding its commitment to the reforms stirred public doubt about policy continuity. As reported by US Embassy and other sources, attempts by the extreme right to dilute the agrarian reform, though largely thwarted by moderate elements led by President Magana, aroused considerable anxiety among peasants. 25X1

Furthermore, an unexpected deepening of world and regional recessions devastated export earnings. Stagnant foreign demand and large world stocks kept the price of coffee low and sent those of cotton and sugar plummeting. In addition, US sugar quotas and the International Coffee Agreement (ICA) imposed constraints on the volumes of these commodities that El Salvador could sell abroad. The government's inability to attract substantial private financing from abroad—despite, according to US Embassy reporting, some casting about by government leaders for a major international bank loan—reinforced pressures on the country's external accounts. 25X1

Table 2 *Million US $*
El Salvador: Balance of Payments

	1978	1979	1980	1981	1982 [a]
Current account balance	−286	35	3	−275	−240
Trade balance	−227	105	100	−192	−160
Exports (f.o.b.)	802	1,130	1,072	794	740
Coffee	386	675	615	452	398
Cotton	98	85	83	53	52
Sugar	19	27	13	14	13
Shrimp	11	12	13	19	24
Other	288	331	348	256	253
Imports (c.i.f.)	1,029	1,025	972	986	900
Net services and transfers [b]	−59	−70	−97	−83	−80
Net private capital inflows	197	−227	−487	−93	−120
Changes in reserves	38	−101	−284	−100	0
Changes in arrears			41	24	−15
Amortization on public debt	20	21	46	81	100
Foreign assistance financial gap	147	112	205	325	475

[a] Estimated.
[b] Excluding official transfers.

Table 3 *Million US $*
El Salvador: Gross Foreign Official Financing

	1981	1982 [a]	1983 [b]
Total	325.0	475.0	475.0
United States	100.0	178.0	205.0
International Monetary Fund	42.5	67.5	35.0
Inter-American Development Bank	61.0	47.5	85.0
Venezuela	40.5	38.5	60.0
Others	81.0	143.5	90.0

[a] Estimated.
[b] Projected.

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Scarce Foreign Exchange and the IMF

Although foreign official financing expanded about 45 percent last year, a severe foreign exchange shortage continued to shackle the economy. The lead in boosting foreign assistance was taken by the United States and the IMF, to some degree in tandem. Assistance from the United States—which, last year, included the largest allocation under the Caribbean Basin Initiative—jumped from $100 million in 1981 to almost $180 million. Other industrialized countries, many of whom have been intent on maintaining political neutrality with respect to the insurgency, provided only minor contributions. An IMF agreement concluded in July, significant as much for its effect on Salvadoran policies as for the financing, pledged $85 million in combined Standby/Compensatory Fund Facility loans over the following year. Nevertheless, the overall impact of the increase in foreign official funding on the balance of payments was largely blunted by the negative export and private capital trends described above.

El Salvador managed to restrain its financing needs and to reduce its current account deficit, but at a high economic cost. Unable to draw further on its depleted foreign exchange reserves, the government was forced to cut its real imports by more than 10 percent. 25X1

To qualify for the IMF loan, San Salvador was obliged to undertake a series of tough austerity measures. Accordingly, the Magana administration: 25X1

- Raised interest rate ceilings.
- Shifted additional international transactions from the undervalued official exchange rate to the parallel rate determined by market forces.
- Limited central reserve bank credit.
- Tightened fiscal balances and reduced public-sector recourse to borrowing.

These measures helped to strengthen El Salvador's balance of payments through import disincentives and to pare the country's large public-sector deficit. The government succeeded in cutting the public-sector deficit as a share of GDP—which had risen from 2.4 percent in 1979 to 8.6 percent in 1981—to 7.5 percent last year. 25X1

At the same time, however, the measures further depressed economic activity. Reduced expansion of bank credit restrained the amount of domestic currency available for private and public sectors alike. With

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tax revenues slumping because of a decline in coffee exports, the government had to slash public investment more than one-third in real terms in order to meet IMF-mandated targets, according to US Embassy sources. [redacted]

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Disappointing Domestic Performance

Together, the renewed guerrilla attacks, scarce foreign exchange, and government austerity caused a 5.5-percent contraction in El Salvador's real GDP last year. IMF data indicate total public and private gross capital formation slid to 11 percent of national output, less than one-half of the 1978 share, as investor confidence waned. All major sectors contributed to the economic decline [redacted]

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Agricultural output, which accounts for one-fourth of GDP and more than one-half of the country's employed labor, fell substantially. El Salvador's three most important crops—coffee, cotton, and corn—were hit especially hard. Coffee production was hobbled by a combination of inadequate maintenance of plantations because of future land ownership uncertainties, a related spread of coffee rust disease, and depressed world demand. Guerrilla attacks and adjustments to the land reform were largely to blame for reduced cotton production; in particular, the US Embassy notes that damage last fall to more than a dozen pesticide-spraying planes and the intimidation of pilots involved in crop dusting probably contributed to major losses at harvest time. Torrential rains, closely following a severe drought, took a particularly heavy toll on such basic crops as corn, beans, and rice. [redacted]

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The industrial and commercial sectors also continued to slide. Demand for their output languished as economic activity in neighboring CACM markets contracted a combined 4 to 5 percent and domestic incomes fell further. In addition, many firms were unable to import critically needed materials and machinery because of severe foreign exchange shortages.[2] Finally, the insurgents obstructed industrial activity by sabotaging power plants, factories, and transportation facilities. The US Embassy estimated

[2] On average, more than 60 percent of the materials used in Salvadoran industrial products have to be imported. [redacted]

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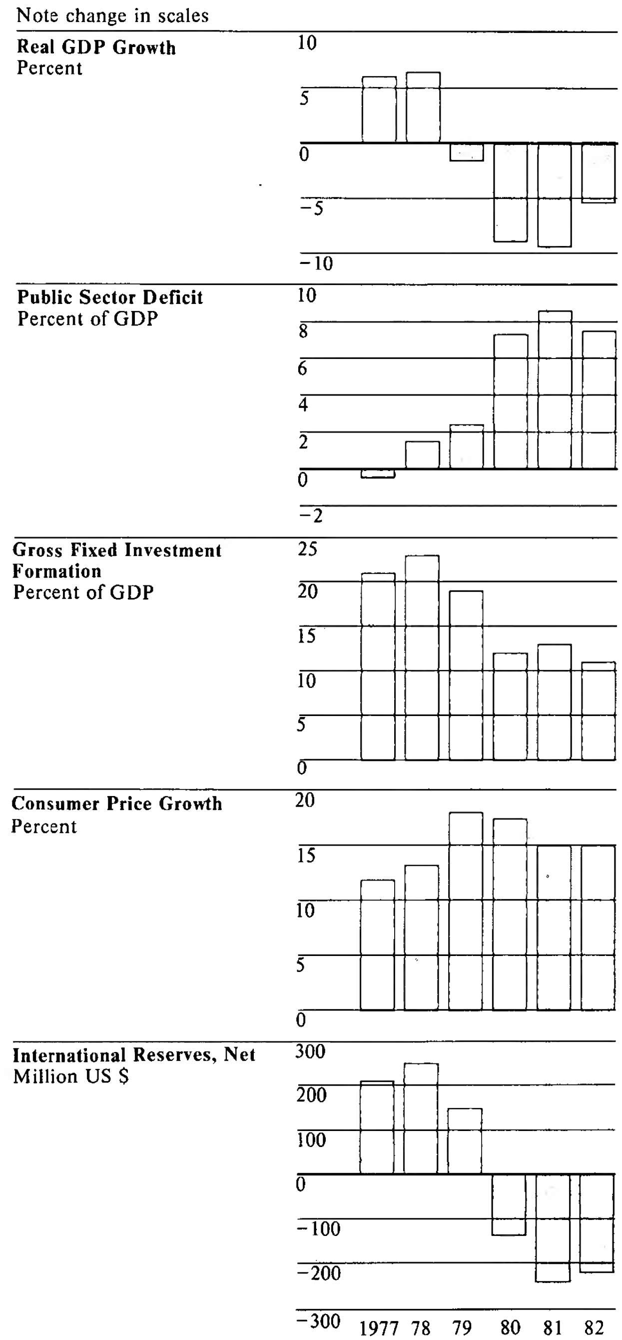
El Salvador: Economic Indicators



[redacted]

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Table 4
El Salvador: Crop Production

Index: 1978 = 100

	1979	1980	1981	1982 [a]
Export Crops				
Coffee	108	106	97	92
Cotton	82	79	57	52
Sugar	87	69	61	75
Basic Crops				
Corn	103	103	98	82
Beans	107	91	88	88
Rice	114	119	122	107

[a] Estimated.

[redacted]

that the interruption of electric power generation alone caused more than $60 million in direct and indirect losses to industrial production last year. [redacted]

Based on a variety of indicators, we believe the social and political impact of the economic slide grew rapidly. A rise in business bankruptcies, reduced agricultural production, and growing numbers of persons displaced by the insurgency swelled the ranks of the unemployed to more than 30 percent, according to the US Embassy. In addition, the personal income and living standards of most workers continued to decline as the government held wage increases substantially below the rate of inflation. Partly due to growing labor restiveness stemming from depressed real wages, several leftist functionaries succeeded in penetrating the moderate Popular Democratic Unity (UPD)—the country's largest labor movement—and gained important leadership positions. [redacted]

Prospects for 1983 and 1984

We believe El Salvador's economic outlook is dim, mainly because the country continues to face the same debilitating low business confidence and scarce foreign exchange conditions, stemming from the effects of the insurgency and a depressed world economy that prevailed last year. In our view, attempts to overcome this situation will be tied inextricably to conditions on three fronts: foreign markets for Salvadoran cash crops and manufactured products, domestic military and political stability, and the willingness of foreign lenders and donors to extend financing. We expect little improvement in export market conditions over the next 18 months despite a gradual revival of world economic activity and demand. Most important, huge world stocks, continued weak prices, and binding ICA quotas probably will keep coffee proceeds depressed near 1982 levels at least through the end of next year. We, therefore, believe that military-political conditions and foreign financing will be the principal determinants of El Salvador's economic performance in 1983 and 1984. [redacted] 25X1

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Because future domestic military and political developments will strongly influence the scale of El Salvador's foreign financing needs, we examine these relationships under three alternative military-political stability scenarios. Thus far, the military standoff between government and guerrilla forces has held up for the most part, the principal exception being the area east of the Lempa River. So, too, has the political accommodation agreed to by ideologically disparate parties in the government coalition. Still, these conditions remain volatile and could take on a dramatically different complexion in a matter of months. [redacted] 25X1

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In each of the three scenarios investigated, we targeted zero growth in 1983—the best we felt possible—and 3-percent growth in 1984 and asked what the implicit domestic and foreign savings requirements would be.[3] In view of the reluctance of many foreign donors and lenders to supply El Salvador with new funds, prospects for meeting the country's foreign financing needs are highly uncertain. At the moment, the government appears to have lined up about $475 million, all from foreign official sources.[4] To the 25X1

[3] See appendix for more details on methodology and assumptions employed in the three scenarios. [redacted] 25X1

[4] The United States, Venezuela, and the international financial institutions are expected to provide the dominant share. Some of these funds, however, could be in jeopardy. The IMF may withhold some $35 million because of El Salvador's failure to meet performance targets, particularly expected reductions in fiscal deficits and external arrearages. Also, Venezuela may reconsider part of its $60 million of scheduled credits because of its own financial problems.

[redacted] 25X1

Second Round Effects: The Insurgency and Industry

While insurgent violence has had its greatest direct impact on the agricultural sector of the economy, it has had an especially detrimental indirect effect on El Salvador's industry. Political instability and deteriorating security have seriously eroded business confidence and have spurred large-scale capital flight, exceeding $1 billion since 1978 by some estimates. By contributing to declines in foreign exchange earnings and by scaring off foreign private investment and credit, the insurgency has also reduced the industrial sectors' access to vital foreign raw materials and intermediate goods. Largely because of these factors, private industrial investment—covering manufacturing, construction, and electric power—last year appears to have been little more than one-fourth of the level attained in 1978 in real terms, according to data derived from a variety of sources. [redacted] 25X1

Production in manufacturing and construction—the most dynamic sectors in the economy until 1979—has been hit especially hard by the combined effects of the insurgency, depressed demand in both domestic and foreign markets, and shortages of foreign exchange. Between 1979 and 1982 manufacturing output declined more than one-third and construction activity declined almost one-half. The share of the manufacturing and construction sectors of GDP dropped from 23.4 percent in 1978 to 18.8 percent in 1982. We believe industrial output in the main San Salvadoran metropolitan area, because it is more dependent on both foreign inputs and foreign markets, probably has fallen as much or more than production in eastern areas more directly under the influence of the guerrillas. [redacted] 25X1

Among the manufacturing industries, activity in the textile, apparel, and metal and mineral products enterprises has slumped most sharply over the past four years. According to the World Bank, an estimated 600 shutdowns of manufacturing firms between 1979 and 1981 were concentrated in these industries. Moreover, employment in most of the firms that continued to operate in that industrial group was slashed. Because enterprises in these manufacturing industries are more labor-intensive than most others, the impact on rising national unemployment has been profound. [redacted] 25X1

The Salvadoran Government views revitalization of the country's industry to be a crucial element in its strategy to promote economic recovery and has taken some significant steps in that direction. In December of last year, it formed an economic recovery committee with high-level joint government-private sector membership to produce plans for projects to revive key enterprises. At about the same time, San Salvador signed a $50 million agreement with the Inter-American Development Bank for fostering industrial development. Still, until political and military stability is restored, new investments in El Salvador's industrial sectors are not likely to increase significantly. [redacted] 25X1

extent that the foreign financing gaps described in these scenarios cannot be filled, they represent potential constraints on the attainment of the growth rates we have targeted for the next two years. The findings of our scenarios are intended to be suggestive, not predictive, and a number of additional variants could be extrapolated from them. [redacted] 25X1

The military and political conditions posited for each of the scenarios are:

- *Scenario I*—Violence stays near last year's level, the tactical military balance between the government and the insurgents remains at stalemate, and political power continues to be wielded by a tenuous coalition of disparate moderate and rightist parties. We believe this to be by far the most likely scenario.

- *Scenario II*—Internal security deteriorates badly and acrimony between moderates and rightists disrupts the functionings of government. The insurgency makes major gains, leading either to a serious deterioration in security or to a government agreement to cede major power to the far left.

Table 5
El Salvador: Projected Foreign Financing Gap, by Scenario

1983	Scenario I	Scenario II [a]	Scenario III
Current account balance	−315	−525	−250
Trade balance	−235	−425	−170
Exports (f.o.b.)	740	600	780
Imports (c.i.f.)	975	1,025	950
Net services and transfers [b]	−80	−100	−80
Net private flows	−35	−100	0
Changes in arrears	50	50	50
Amortization on public debt	125	125	125
Financial gap	525	800	425

1984	Scenario I	Scenario II [a]	Scenario III
Current account balance	−375	−800	−225
Trade balance	−300	−700	−175
Exports (f.o.b.)	800	500	900
Imports (c.i.f.)	1,100	1,200	1,075
Net services and transfers [b]	−75	−100	−50
Net private flows	−25	−150	25
Changes in arrears	0	0	0
Amortization on public debt	150	150	150
Financial gap	550	1,100	350

[a] Scenario II is not intended as a projection but merely an illustration of general orders of magnitude based on military-political assumptions offered in appendix A. Data for the autarky case mentioned in the text are not shown here; based on a few comparable experiences in other countries, however, we believe that imports and the financial gap could fall in this special case as much as $100 million in 1983 and $300 million in 1984 below levels depicted in Scenario I.
[b] Excluding official transfers.

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- *Scenario III*—The government gains the upper hand militarily and all national unity political parties strengthen their commitment to justice and democracy. A weakened insurgency boosts business confidence and possibly convinces some leftists to join free elections. We believe Scenarios II and III share an equally small likelihood of occurring.

In all the scenarios, private-sector confidence would serve as the principal barometer for evaluating the economic effects of political-military developments. With a continuation of past security conditions envisaged under Scenario I, the private sector would play a restrained yet important role in the country's economic affairs. In Scenario II, major intensification of guerrilla action and/or the placement of Marxist leaders in key government posts would probably precipitate a crumbling of most of the remaining private sector. As a corollary, the improvement in both 25X1

security conditions and business-government relations in Scenario III would stimulate a major expansion of private-sector activity. [redacted]

Scenario I—No Major Changes in Military or Political Situation

In this scenario, guerrilla forces continue to show sizable strength and to mount frequent attacks on economic and other targets in some areas of the country, particularly east of the Lempa River. At the same time, however, they prove unable to extend their influence significantly in new areas. The national unity government continues to resolve political differences through compromise but is handicapped in its ability to take bold initiatives or make controversial decisions, such as whether or when to implement the suspended Phase II of the agrarian reform. In this environment, few private producers would be moved to commit significantly greater resources to the economy, although those who have persevered so far would not be likely to cut back. [redacted]

For El Salvador to arrest its economic slide in 1983 and mount a 3-percent recovery in 1984, it must be prepared to finance rising deficits on its external current accounts. We calculate that total import expenditures may need to be increased some 8 percent this year and 13 percent in 1984 to restore depleted stocks of industrial raw materials, intermediate goods, agrochemicals, and spare parts. Meanwhile, in our judgment, export earnings in this scenario would show no growth this year and only a moderate rise in 1984, primarily because of continuing depressed proceeds from the country's two leading export commodities—coffee and cotton. While unfavorable world market conditions would restrain coffee exports, guerrilla intimidation of farmers would result in declining cotton output and export earnings. [redacted]

If, as we expect, foreign private investors and lenders remain chary of El Salvador, the burden will fall to foreign official assistance to fill a financial gap of $525-550 million each year. These funds will be required to cover not only current account deficits in the $300-400 million range but also amortization on public debt, which we project to rise some $25 million or more a year to $125 million in 1983 and $150 million in 1984. In addition, because of limited domestic financial resources, the local currency generated from foreign assistance will contribute importantly to the government's efforts, under IMF direction, to meet the credit requirements of the private and public sectors. [redacted] 25X1

Currently projected foreign assistance of $475 million in 1983 and $500 million in 1984 will not allow El Salvador to meet the import levels consistent with our GDP targets of zero real growth this year and 3-percent real growth next year. We believe the import squeeze mandated by these financial shortfalls will lead this year to a moderate decline—up to 5 percent—in national ouput. As in the past, tight foreign exchange supplies probably will hit the manufacturing and construction sectors the hardest. Agricultural production, although also affected, will remain primarily subject to the vagaries of weather and guerrilla activity. [redacted] 25X1

Scenario II—Military and Political Conditions Deteriorate Sharply

An expansion of the insurgency or an outbreak of bitter squabbling between the rightist and moderate factions of the government would seriously hurt the economy and would greatly increase the amount of foreign financing necessary to support our growth targets. [redacted] recent military successes have given the guerrillas some—at least temporary—territorial gains, worldwide attention, and a boost in morale. Should increased guerrilla aggressiveness gather momentum and lead to major gains in territorial control, remaining business confidence would evaporate, thereby causing an acceleration of capital flight and a further exodus of managerial and technical talent. [redacted] 25X1 25X1 25X1

Assessments of El Salvador's foreign financial needs under conditions of an increasingly successful guerrilla campaign could go in one of two directions that make precise projections difficult. The leftists could gain such a large role in policymaking that San Salvador would opt for an autarkic approach, in which living standards, imports, and foreign aid requirements would be compressed. [redacted] 25X1 25X1

If, however, the military-political situation caused a serious deterioration in security but did not alter the basic thrust of foreign and economic policies, foreign

financial needs could skyrocket. A growing number of business and factory closures would mean slumping manufactures exports. Many rural landowners, fearful of devastating financial losses, would curtail their export cash crop operations. Moreover, shortages of food and other consumer goods would be likely to drive up overall import requirements. Meanwhile, government expenditures probably would greatly outstrip flagging revenues, reflecting not only growing needs for defense and social services but also an enlarged government role in keeping the economy running.

We estimate that El Salvador, with a continuation of existing governmental policy orientation, would require enormous foreign financial assistance to meet our GDP growth objectives, perhaps a multiple of the amount needed under Scenario I. At currently projected levels of foreign assistance, however, economic activity could shrink at an annual pace exceeding 10 percent.

Scenario III—Improved Military and Political Conditions

A reduced guerrilla threat and progress toward political democratization probably would lead to a resuscitation of the private sector, although full benefits would not be realized until after 1984. This scenario probably would entail the government pushing a more effective civic action program, taking the military initiative with more successful counterinsurgency tactics, and holding free and democratic elections by the end of the year.

Some short-term economic gains might be achieved simply by utilizing existing productive capacity more fully. Reduced risk of terrorist attacks would enable farm owners to attain substantially greater crop harvests. In addition, enhanced government protection of electric power facilities in and around the eastern city of San Miguel, the country's third-largest industrial center, probably would permit significant increases in industrial production. We calculate that rising output of cash crops and manufactured goods might spur an expansion of export earnings amounting to some $50 million in 1983 and much more in 1984.

We believe an expansion of private capital formation also would occur, but more slowly. Domestic and foreign businessmen would be likely to proceed cautiously until they were convinced that the improved military and political conditions would endure. At the same time, however, the public sector might be in better financial position to contribute to economic recovery as a result of diminished defense needs and substantially higher export tax revenues. Under these favorable circumstances, we calculate that the flow of foreign financial assistance now envisaged through the end of 1984 would appear to be sufficient to 25X1 permit zero growth this year and probably more than enough to support 3-percent growth next year. 25X1

A Look Beyond 1984

We believe El Salvador has no chance of returning to past rapid growth rates until it restores political and military stability. Even then, a joint effort by the 25X1 government and the private sector to recreate a foundation for sustained growth probably would be essential. The government will need to attach high priority to the rebuilding of damaged roads, railways, bridges, and power facilities. To promote higher efficiency, San Salvador must also relax controls over trade, interest, and prices, as well as assure ample allocations of foreign exchange and domestic credit to the private sector. Private enterprises must modernize equipment, rebuild diminished stocks of materials, and strengthen their financial structures. Partly because foreign investors and commercial bankers will 25X1 respond only gradually to improved political and economic conditions, foreign assistance will probably continue to play an important role for some time.

El Salvador, in our view, also will need to give greater 25X1 emphasis to developing and diversifying its industrial sector, considering its limited agricultural land and its large and rapidly growing population. In particular, a major increase in output of labor-intensive manufactures for export to non-CACM markets could contribute importantly to the generation of employment and

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foreign exchange. We doubt that El Salvador can count on continued, rapidly expanding foreign markets for its cash crops to meet its large foreign exchange needs. 25X1

Still, agriculture will continue to be important, especially for absorbing the country's rural unemployment and for providing inputs to major coffee and food processing industries. Accordingly, San Salvador could raise farm output to or above peak levels of 1979 without difficulty by resolving the outstanding agrarian reform problems, expanding irrigation, and increasing fertilizer applications. Making a clear decision either to expedite implementation of the agrarian reform's Phase II—which contains major areas of coffee and cotton farmland—or abandon it altogether would by itself stimulate increased production by dissipating uncertainty. 25X1

Appendix

Methodological Notes on Economic Forecasts

Sources

The compilation of historical data and estimates of projected trends contained in this assessment draws on official Salvadoran statistics and a variety of other information and analytical sources, most notably US Embassy reporting and publications of the International Monetary Fund (IMF) and World Bank. We chose the broadly accepted IMF definitional formats in instances when differences arose between the Fund and San Salvador about data interpretation and presentation, particularly regarding external accounts. Furthermore, our scenario forecasts were based on certain assumptions regarding future world economic trends, including oil prices, world and regional economic growth, and commodity prices. These data projections were derived from CIA-constructed estimates.

Financial Gap Analysis

Our projections for foreign financing requirements for 1983-84 were calculated as the amount of funds needed to close projected foreign exchange gaps associated with certain economic growth tracks under three varying military and political stability scenarios. This financial gap was calculated as:

$$FG = (I - E + ST) + A + P$$

where FG equals foreign financing gap, I equals import expenditures, E equals export earnings, ST equals net outflows of services and transfers, A equals amortization of medium- and long-term public debt, and P equals net flows of private capital, including errors and omissions.

Exports were calculated as the product of projected volume and international commodity prices. The projected volume of agricultural exports—predominantly coffee and cotton—was determined according to the expected impact of international quotas (coffee) and the insurgency (cotton). Commodity prices for 1983 and 1984 were estimated using the Box/Jenkins statistical analysis, employing the latest information regarding stocks and evolving market conditions. In general, coffee prices are expected to remain relatively constant over both years while cotton prices are projected to fall slightly in 1983 followed by a mild recovery in 1984. Projections of Salvadoran manufactures exports reflect our judgment that CACM countries, beset by financial problems of their own, probably will not absorb substantially greater amounts of Salvadoran goods through 1984. 25X1

Net Services and Transfers consisted primarily of known and anticipated interest obligations on foreign debt, profit remittances, and direct grants. 25X1
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Imports took into account anticipated needs of both the producing sectors and the consuming population in 1983 and 1984. Accordingly, we estimated the amounts of foreign productive inputs required to sustain zero growth this year and 3-percent growth next year as well as what we believed to be the minimum politically acceptable level of nonproductive imports. For this purpose, we disaggregated Salvadoran imports into the following five broad producer-related and consumer-related categories: food, other consumer goods, fuel, raw materials and intermediate goods, and capital goods. Our analysis led to these judgments:

- Pressure for increases in food imports will be high in view of recent large losses of domestic basic grain output.
- Little increase in imports of other consumer goods appears necessary. Though cut considerably below pre-1979 levels, this category of goods has not been pared to the bone. 25X1
- Fuel import costs can continue to be held down as a result of the development of hydroelectric and geothermal resources and declining oil prices.

Table 6
El Salvador: Import Volume, by Category

Index: 1973 = 100

	Food	Other Consumer Goods	Petroleum	Raw and Intermediate Goods	Capital Goods
1974	97	96	89	126	110
1975	111	96	80	99	144
1976	110	103	80	124	185
1977	128	168	101	143	214
1978	158	163	107	141	227
1979	138	153	119	129	164
1980	175	126	97	105	76
1981	175	94	82	102	69
1982 [a]	179	82	89	94	50

[a] Estimated.

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- Imports of raw materials and intermediate goods will need to be substantially increased to replenish seriously depleted inventories.
- Moderate increases in capital goods imports—to 1980 and 1981 levels—probably are needed simply to provide essential replacement equipment and spare parts.

Amortization included scheduled repayments of medium- and long-term debt of the government, government-guaranteed, or of the Central Reserve Bank. Comparable data for private debt do not exist. The bulk of the amortization on private debt is for short-term loans, much of which characteristically has been rolled over in recent years.

Net Private Flows encompassed all private flows on capital account, including investments as well as short-, medium-, and long-term credits. Since 1978, capital flight has weighed heavily in the totals. Because substantial flows of private capital have not been traceable through the international banking networks, San Salvador has been compelled to lump "errors and omissions" in with this category of transactions.

Three Political-Military Scenarios

Under *Scenario I,* the principal change from 1982 in El Salvador's balance of payments would occur in its imports. We believe the country would have to boost its import expenditures roughly 8 percent in 1983 and 13 percent in 1984 to meet our specified GDP growth targets. Of these increases, we expect rising import prices in each year will account for 4 to 5 percentage points, comparable to the price pressures experienced in 1982. Approximately two-thirds of import bill increases over the two years would consist of purchases of foreign raw materials and intermediate goods. Based on an evaluation of historical import data for this category, it appears that a rise of this magnitude would be in order to bring national inventories up to levels more closely in line with normal stock-industrial output relationships. The remainder of El Salvador's rise in imports, according to our analysis, would be divided mainly between food and capital goods procurement.

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If military and political conditions slip considerably as suggested in *Scenario II,* it would be impossible to specify the economic impact. A far-leftist accession to political power could result in El Salvador's diminished dependence on foreign financing and a substantial fall in economic activity. Based on experiences in Cuba following Castro's seizure of power and in South Vietnam following its conquest by North Vietnam, we believe foreign financing could be cut as much as $300 million below the amounts shown in Scenario I. If the Salvadoran Government persists in its struggle against the insurgents, it will likely look to increased foreign financing to prop the economy. How much would be needed, however, would inevitably depend on just how badly military and political conditions worsen. [redacted] 25X1

Nonetheless, we believe it would be useful to suggest some orders of magnitude under somewhat conservative "deterioration" assumptions. The impact of conditions under this scenario would be felt on exports, imports (beyond those described under the first scenario), and net private capital flows. If we were to assume that the direct damage inflicted on El Salvador's ability to produce would be three times that wrought in 1982, we could probably make the following claims:

- Export earnings probably could be expected to fall some $100 million or more a year. Cash crops, cultivated and harvested in the least secure outlying areas, would be especially vulnerable to destruction.
- Emergency needs, particularly for food, could swell the country's import bill up to $50 million a year.
- Although most domestic capital that would be inclined to leave the country has already left, renewed capital flight would probably accelerate to more than $100 million a year. [redacted] 25X1

We have distinguished *Scenario III* from the other scenarios primarily by its higher exports. For example, without significant guerrilla harassment, farmers probably could raise their exports of cotton and sugar substantially. Moreover, a more stable political environment in El Salvador would be conducive to an increase in industrial production for export markets. Some reduction in imports may be possible also, as fewer materials, parts, and equipment would be needed to replace capital stock damaged by the guerrillas. Foreign private investors and lenders would once again begin to take a strong interest in El Salvador, but the major effects probably would not be evident until after 1984. [redacted] 25X1